RICHARD RUSSELL'S **DOW THEORY LETTERS, INC.**

P. O. Box 1759, La Jolla, California 92038
Minimum of 26 Letters per year — $185 Annually
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**December 17, 1980** **LETTER 798**

Dec. 5, DJIA 956.23; PTI 1363; A-D ratio –17.60
Dec. 12, DJIA 917.15; PTI 1346; A-D ratio –19.25

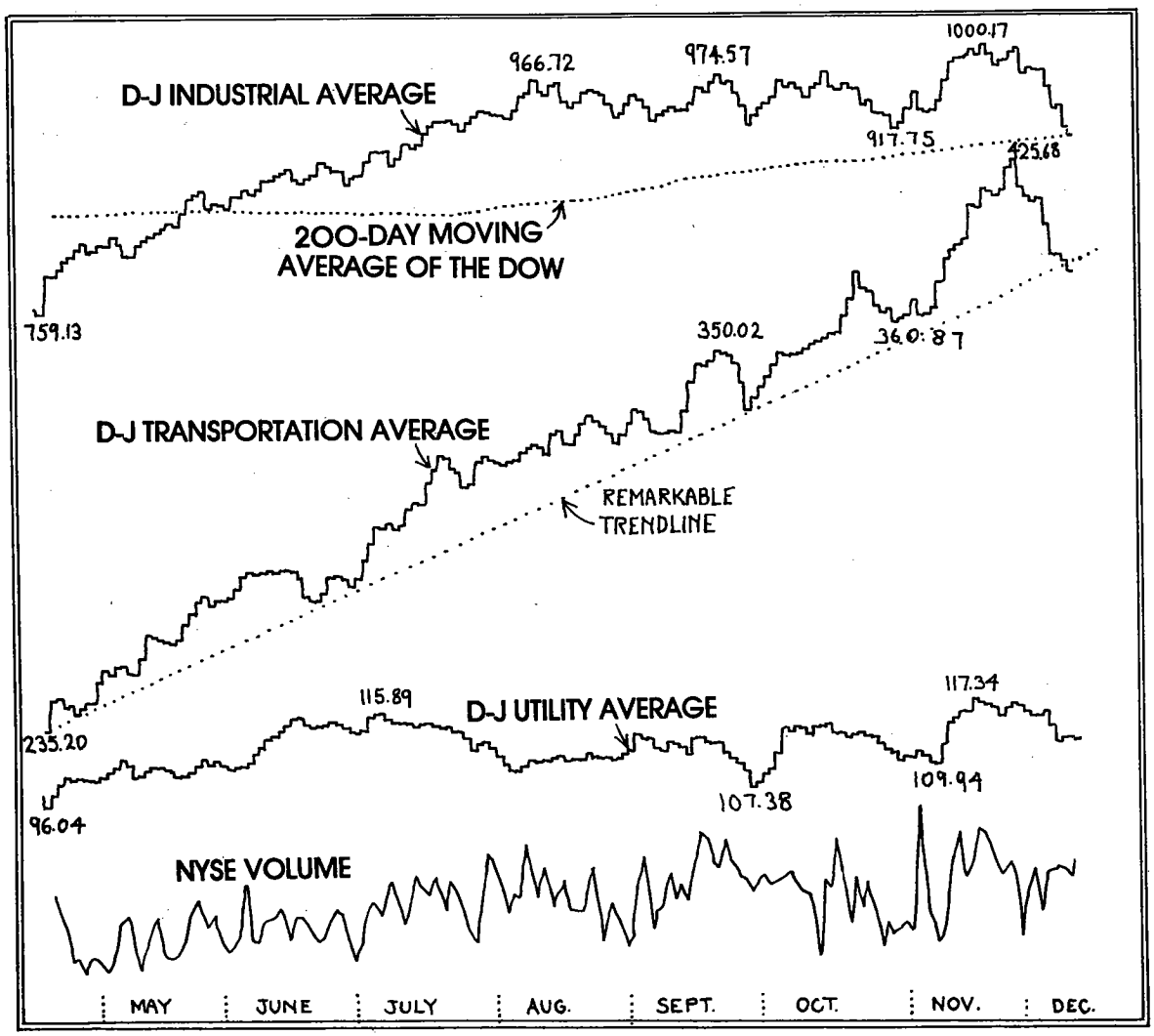
**THE MARKETS:** Chaos and slaughter in the bond market, agony and destruction in the commodity markets , sickening slides in the precious metals markets. In the stock market a rip-roaring sell-off has mangled all sectors of the market. As I see it, one paw of the bear has fallen on Wall Street. But the other paw, while paused, has not yet dropped.

Let's take a cold, unemotional look at the technical picture. On the daily chart below you see that the D-J Industrial Average on December 11 closed at 908.45, well below its November 30 low of 917.45. But the Transportation Average has not yet confirmed. A bearish downside confirmation would entail Transports breaking 360.87, the November 30 low. Food for the bears, however, stems from the Transport action of December 11. On that day Transports closed below a 7-month rising trendline as seen on the chart. Thus, the upside momentum of the carriers has been broken.

A remarkable performance has been put on by the highly interest-sensitive Utilities. It is notable that the Utility Average, despite

**FRONT PAGE COMMENT:** I've said for months that INTEREST RATES would be the big story for late-1980 and 1981. I'll stick to that forecast. But there's one fascinating thing about an explosion in interest rates. As much as it hits everybody else adversely, it rewards the holder of cash. Right now Cash Longreen is having a picnic. He can get a yield of 16% on T-bills, many liquid asset funds pay over 14%, and bank CD's pay around 17%. As they say in New York, "How can you hate it?"

I've observed over the year that the biggest bonus goes to the investor who owns what no one else has. Thus, in 1942, 1949, 1957 and 1974 it was stocks. In 1970-72 it was gold. In the mid-1970's it was collectibles: stamps, coins, art, antiques. What is it that no one has now? It's cash, cold, hard cash with no mortgages, no debts, no liens against it. For a decade we have been told that "cash is dirt, get rid of it!" The only way to survive, we were told, is to own "things." And that kind of thinking was correct in the past. But today the shoe is on the other foot. Today, the lender is getting paid–at mouth-watering rates. And he doesn't have to lend his cash for more than 91 days!



soaring interest rates, has not violated its September 28 low of 107.38 or even its November 7 low of 109.94.

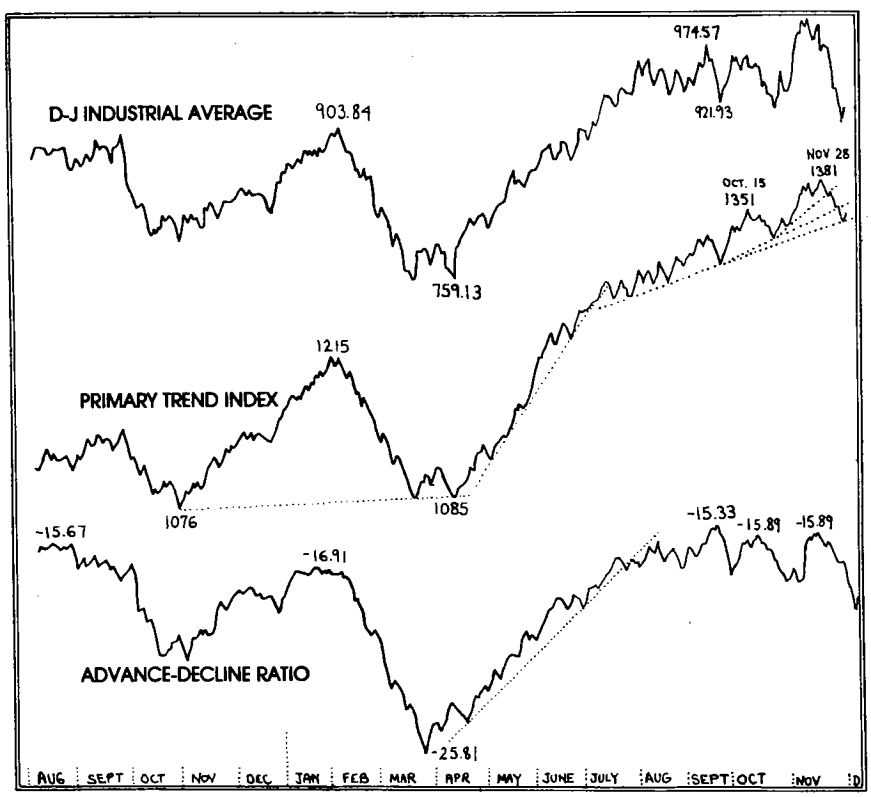
Finally, I am watching the 200 day moving average of the Dow. This indicator now stands at 905, and the ability (or inability) of the Dow to hold above the 900-905 level will be significant.

So there you have it: a battered and bruised stock market, but a stock market with only one paw of the bear upon it. The other paw will drop (from a Dow Theory standpoint) if Transports smash the 360.87 level. Until 360.87 is broken, however, the bulls can still cling to a bullish thesis.

Large, informed investment interests have priorities when it comes to putting their money on the line. The priorities are as follows: (1) the most important is *safety* of principle. (2) Next in importance is *return* on the investment. (3) Last in importance is potential or *possible appreciation*. Treasury bills now rank super-high in numbers 1 and 2, and that tells you a lot about what's happening in the market now. The big money is moving into short-term, high yielding government paper. Let me put it another way–the stock market will always be there, but 17% T-bills are a rare phenomenon and a great value. And as veteran subscribers know, this writer has always had a weakness for great values.

Next, let's turn to my daily chart of the Dow, the Primary Trend Index (PTI) and the A-D ratio. Note that the A-D ratio has smashed well below its October-November low.When, on December 10, the Industrial Average cracked its November low, it confirmed the A-D ratio. The weakness in the breadth-price syndrome is therefore undeniable.

The PTI is my own proprietary index, an amalgam of 8 crucial market averages and indices. I have placed primary importance on the ability of the PTI to hold above its latest rising trendline. Over the past week (as shown on the chart) the PTI has cracked




Meanwhile, the panic for cash has not been painless. Over the past few weeks markets from soy beans to bonds, from copper to common stocks, have been battered unmercifully. I would guess that the total loss in market values during November-December (including mortgages, bonds, stocks, commodities, and precious metals) ran far over $100 billion). In all my years of watching markets, I don't think I've seen anything like it!

two lesser trendlines, one only a few weeks long and the other going back to September. On December 11 the PTI came down EXACTLY to its rising trendline, the fourth time it has done this since July. On each previous instance, the market has reversed and an explosive rally has been set off. So let's see whether history repeats–or whether this time the PTI is fated to break below that fateful trendline. I will comment further on this cliff-hanger in "Late Notes" at the end of this Letter.

Conclusion: Technical damage has been building in the market, particularly in the breadth-price relationships. As subscribers know, I've been opting for T-bills for some time, even while the PTI has presented a bullish profile for the market. Thus it comes as no surprise to me that a veritable panic for cash (and an exit from everything else) sweeps the markets during this period of sky-rocketing interest rates. I always like a sure thing, and the only sure thing in investing is the fat returns brought on by compounding high interest rates.

**MONEY, MONEY:** If business slows down, interest rates will topple–right or wrong? Right in normal times when total debt is manageable. But for today, the statement is wrong!

The statement is wrong because debt in the US is climbing at an exponential rate (i.e., an exponential curve is a curve that rises at an increasing rate until eventually it goes into a perpendicular ascent). Now all this debt must be serviced, and therefore the servicing costs are rising at an exponential rate as well. The only way this kind of rise in debt-costs can be serviced is in a society where cash flow and profits also rise at an ever-increasing rate. But of course that cannot and will not happen.

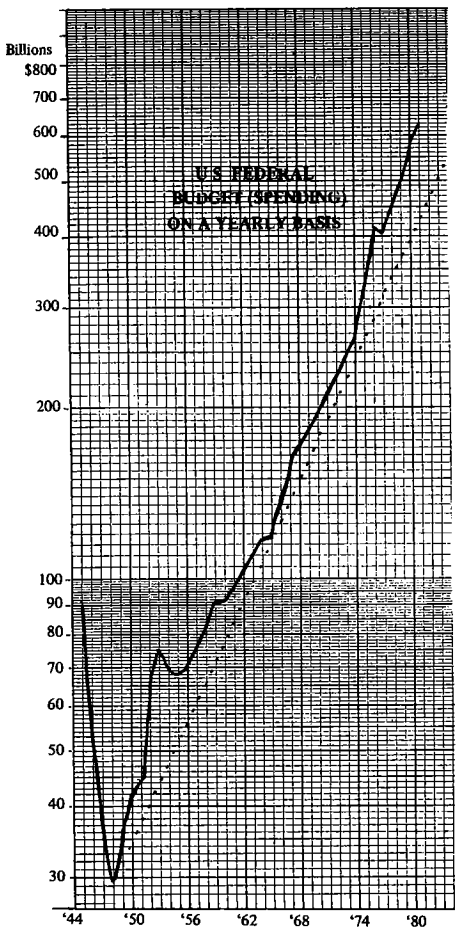
But what happens if the debt (as it is now doing) rises at an increasing rate and the economy moves sideways or (worse) slides? In that case, the pressure brought on by servicing the debts puts the big squeeze on the market. Remember, business can slump, people can be laid off, profits can fall, but the debt and the cost of servicing the debt remains. It does not evaporate along with sales and profits.

All of this is happening independently of the Fed. The Fed can raise interest rates, the Fed can vary reserve requirements and adjust stock margins, but the Fed cannot pay off or erase debt. The Fed can stand on its head, but the cost of servicing every bond, note, bill and mortgage in the US REMAINS. Actually, the Fed's stance right now is not terribly "tough" or tight. The current squeeze in the money markets is occurring because of rising borrowing, debt and lack of cash flow, not because Volcker and the boys are putting the economy on the rack.

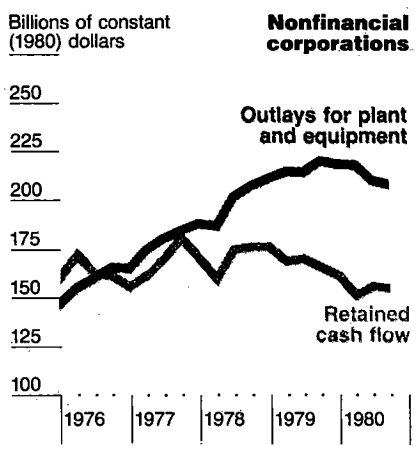
I like charts because they display graphically what it usually takes pages of writing to do. Last week I drew up a chart of US Government spending from 1945 to date. I just wanted to see what the whole thing looked like on a semi-log or ratio chart. Here's

the chart, and if this doesn't scare you–you don't understand the situation!

Few people realize it but interest on the careening debt is now the third biggest expense in the US budget. Interest on the debt for the fiscal year ending Sept. 30 was $79.5 billion. The estimate for interest on the debt (just revised) for 1981 is $90 billion. Now $90 billion is almost $2 billion a week! Because of this and because of boosts in military spending, the new estimate for the 1981 US budget deficit is around $50 billion. But my own guess is that the deficit will be nearer the $70 to $100 billion area. All this, by the way, makes the odds for Reagan's 10-10-10 tax cut mighty slim.

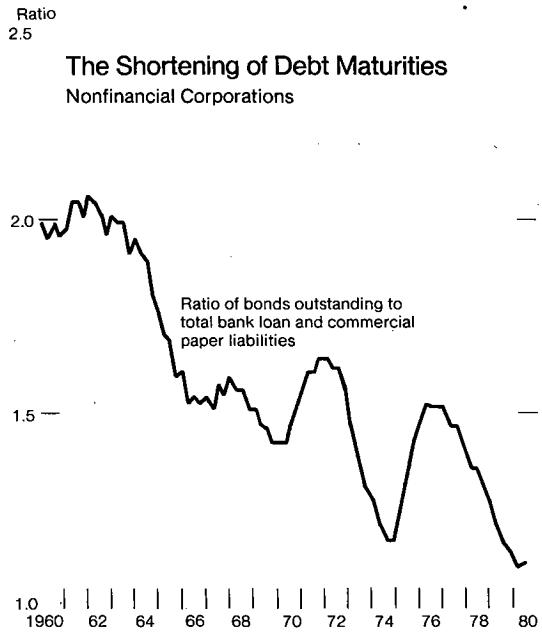



The impact on the money markets of the rising spending and deficits is going to be enormous. The US Treasury will need at least $25 billion in new money during the first quarter of 1980 and $55 billion through the six months ending in June, 1981. This represents a 20% increase over last year. Add to this a severe short-fall in corporate and individual cash flow and the money markets will be facing "the vice."




The accompanying chart (from *Fortune* magazine) shows what is happening at the corporate level. Projected outlays for plant and equipment are running above $200 billion while retained cash flow is around $150 billion.

Ordinarily corporations would come into the money markets to make up the difference. But in today's money market you can forget it! Corporations are going to think three times before borrowing, and the result is going to be major slashes in outlays for plant and equipment in the period ahead. This is the formula for a new recession.




SOURCE: Flow of Funds Accounts, Federal Reserve System.

There's another area of the debt picture that worries me, and it is the shortening of total debt maturities in the US as fewer and fewer corporations (and this also includes the Government) are able to finance in the long-term debt markets (see chart). This is having the effect of gradually moving all debt instruments into the under-five years maturity category. Worse, many secondary corporations do not have the credit to sell anything in the debt markets and they will turn increasingly to the banks for loans. Final result: tremendous pressure at the banks from corporations that must "raise cash or sink." At such time, the full effect of the money-vice will be revealed.

**BONDS, MONEY RATES:** My advance-decline line for the NYSE Bonds (Letter 796, page 3) has smashed to a new low. Government bonds (long-term) have tumbled to historic lows with many bonds now yielding 13%. The D-J 20-Bond Average also collapsed to a record low (61.70 on Dec. 11). Municipal bonds have led the parade down, and many long-term muni's are now yielding an incredible tax-free 12% or better. In a phrase, the money markets have moved to the edge of the abyss.

As for pressure on the markets, it can be seen in the amazing spread between the short-term or 91-day T-bills and the one-year T-bills. This spread on December 11 reached a remarkable 3.2% in favor of the 91-day T-bills. Which means, of course, that the demand for very short term money is tremendous!

Financial analysts are still vying with each other in calling the "top" for interest rates. Seldom has a game been so costly. My own feeling is that the top will come in 1981, but that the top, once here, will not give way to collapsing yields (as has been the case before). I think interest rates could remain high for some time. Playing the interest rate guessing game should therefore continue to be costly during 1981 (just pick 3 or 6 months maturities and sit tight. The chance for a speculative killing in the bond market has not yet arrived).

**NEW ITEM:** I've often toyed with this idea, but I've never actually done it. So here goes. I'm going to include a box in each Letter which will provide subscribers with my idea of where and how their assets should be positioned. I want to say right now that as far as stocks are concerned, I probably will not specify individual stocks unless I believe the market is in a great buying area such as 1974 (actually a bear market bottom). Barring a

major bear market bottom, I will probably recommend leading no-load mutual funds for the average subscriber. Funds picked will also have "switch" capabilities, which means that with a telephone call you can immediately switch your stock fund to a liquid assets fund.

A few of the funds which I like now are *Guardian Mutual Fund*, 522 Fifth Ave., NYC 10036. *Mutual Shares*, 170 Broadway, NYC 10038, *Fidelity Equity Fund*, 82 Devonshire St., Boston, Mass. 02109, *Rowe Price New Era Fund*, 100 E. Pratt St., Baltimore, MD 21202. Write for perspectives on these funds.

**INVESTMENT POSITION:** The position now recommended is a token 10% (or less) in a no-load stock funds and 90% in US Treasury bills of 91 day maturities. For those in very high tax brackets, you can buy project notes (PN's) which are issued by HUD (under one year maturities) and now yield about 7.5% tax free. If you buy one from your own state or from Puerto Rico, they are also free of state taxes. The PN's have behind them the full faith and credit of the US Government and are therefore considered extremely safe. You can buy PN's through your bank – PN's are auctioned off by HUD about twice a month.

The no-load fund position will remain in force as long as the PTI is bullish. A token position of only 10% is recommended because the risk-reward in T-bills as compared with stocks is so strong in favor of totally safe T-bills.

As for gold, with the gold/stock ratio in favor of stocks and with the risk/reward in favor of T-bills over all other investments, I would limit gold positions to a mere 5-10% of assets. The cost of carrying large amounts of gold (in view of today's towering interest rates) again militates in favor of T-bills.

**NOTES & QUOTES:** From Dr. Henry Kaufman of Salomon Bros. "*The rapid growth of debt continues. At the end of this year credit market debt will total an estimated $4 trillion as compared with $1.6 trillion in 1970 and $800 million in 1960. Debt therefore increased at an annual rate of 7.5 in the 1960's and 11.5% in the 1970's. If this acceleration continues in the 1980's, then there will be no way out except through the destruction of values and damage to our economic and political system.*"

* *

Robert Salomon (Salomon Bros.) shows that a stock holder will have to hang on for 11 years before the income on his stock catches up to the income now available on high-grade long-term bonds – even if dividends grow at an 11.2% rate over the period (which is a good rate of growth) ... Thanks to Peter Bernstein for this quote.

* *

Do you ever get depressed about market losses? Then this should ease your pain. On November 25 Kirk Kerkorian took what must be one of the great paper losses of all time. Here's the story:

## Kerkorian 'Loses' 68 Million on Stock

**LOS ANGELES, Nov. 25 (UPI) — Shares in MGM Grand Hotels Inc. closed today at 8½ on the New York Stock Exchange, down ½ from yesterday and 4½ from Friday, representing a paper loss of $68.8 million to Kirk Kerkorian, the financier, who owns about 50 percent of the company's stock.**

* *

Unfortunate Words Dept: Alfred Bloomingdale, a Reagan confidente, whispered this to the press a week ago: "*Running the government is like General Motors. It's three times General Motors – but it's General Motors. We're going to surround Ronnie with people of experience, the very best people in America.*" Bloomingdale didn't mention GM's loss for the third quarter – $953 million!

* *

If the portfolio of various bank and thrift institutions were computed at market value, there's no doubt in my mind but that many would be "under water." The total amount of bond and mortgage losses in the US have to be absolutely staggering. Some institutions, in fact, are tired of taking losses. And below we see what may be the trend of the future, no more fixed-rate paper. Will the wonders of "creative credit" ever cease?

**PHILADELPHIA (UPI) – The Philadelphia Saving Fund Society said it will no longer issue fixed-rate mortgages to home buyers.**

**PSFS, the nation's largest mutual savings bank and the region's leading home mortgage lender, made the announcement this week following the state banking department's decision Saturday to allow mutual savings banks to offer the flexible-rate mortgage.**

* *

The US is not the only super-power with troubles. The Russians are now facing major problems. The biggest are (1) Energy: Russian oil production is levelling off. Their energy goals are not being met, and Russia is preparing for an energy crunch. (2) The Russian agricultural picture is a disaster. Targets for grain production in Russia are not near to being met. (3) There is a manpower shortage in Russia which is expected to be 8 million short by 1985. Thus, the incentive for slave labor (political prisoners) is strong. (4) Russia is spending $7 million a day in Cuba, huge sums in Afghanistan, and they are spending "through the roof" on their military. In fact, it is thought that expenses are holding the Russians back from a trip into Poland. All in all, the cost of building and sustaining the Russian war machine is producing huge pressures on the Russian economy, and the declining standard of living is beginning to worry Russian leaders.

* *

My wife, Paula, and I spent a most interesting evening last week with market analyst Joe Granville, a man of many talents. I haven't seen Joe since 1961, but when he walked into the restaurant I spotted him in a second – because he looks the same as he did in 1961. I asked Joe how he stayed so young. "My secret in three words," he replied, "I never work." That was Joe's way of telling us that he loves the market so much that it's all fun to him. Joseph then discussed everything from earthquakes (he says one is due in California next year on April 10) to numerology, from market trends to beautiful women. In all, a fine evening with a very unusual friend. And I still don't know where he gets all his energy from (Joe sleeps 5 hours a night and dashes about the earth during the other 19 hours of each day).

* *

The hero of the Reagan Administration could yet be Dave Stockman, the new Director of the White House Office of Management and Budget. This guy believes in slashing government expenses in a big way. Stockman begged off a potential job as head of the Dept. of Energy. Reason: he wants to get rid of the whole Energy Dept. Amen!

* *

Would you believe all the clips below came from a single issue of last week's Wall Street Journal!

> "I think at least half the increase in loan demand we're seeing is due to weakening corporate liquidity. Cash flows are weaker than expected, corporations are unable to go to the bond market to finance their needs and more and more are being pushed out of the commercial paper market."

> "To an increasing extent, the loans are needed to finance involuntary inventory accumulation," says Judith Mackey, of Townsend-Greenspan & Co.

> Mr. Kaufman predicted that new credit demands next year will skyrocket to record levels. Corporations' financing needs in 1981 will rise 18% to a record $125 billion, he said, as a result of greater corporate operational requirements and a likely increase in the acquisition of net new liquid assets. The U.S. Treasury, he predicted, will finance a budget deficit of around $55 billion next year. Reacting to the generally gloomy predictions, one attendee of last night's meeting said, "When you hear it drip by drip, it sounds better than when it all comes in a torrent."

> Analyzing the latest Fed figures, Mr. Kudlow of Bear Stearns said total adjusted reserves in the banking system have rocketed at a 41.6% compounded annual rate in the past four weeks. "How anyone can call that restraint is beyond me," he said. He added that the Fed may soon decide to raise reserve requirements on increases in deposits.

> **Ford Motor Co.** has borrowed $725 million in the past two weeks despite soaring interest rates and disclosed it may take more short-term loans by year-end. Banking sources say the total could near $1 billion.

> The $616 billion that President Carter proposed to spend for fiscal 1981, for example, does not include the $100 billion in federal loan guarantees, the $100 billion to $150 billion in federal tax subsidies, the billions in quasi-public enterprise activity, let alone the $40 billion to $100 billion in federally imposed regulatory costs.
>
> In short, a veritable "hidden budget" has taken shape that rivals the explicit outlay budget in both scope and scale, yet is not effectively part of the budget process in any but the most tangential way.

**HERE'S RONNIE:** You're Ronald Reagan and you've just assumed the job of President of the United States. The talk is over, and now you're going to have to act. You go over the statistics again and again, and you try to stifle those gnawing doubts and questions. Here's the US, headed for a trillion dollars in a Federal debt this year. You promised tax cuts (10% three years in a row), and you know those cuts would be very welcome by the people. But you also know that Carter in 1980 spent the money that could be used for a tax cut, and that a 10% 1981 tax cut would therefore produce huge deficits.

Futhermore, you promised large boosts in military spending, but even the boosts that you promised aren't really going to be enough to move the military into fighting shape. You know that the tax cuts are supposed to lift the economy out of its current slump, generate prosperity and higher personal income and corporate profits. That, in turn, is supposed to bring in additional tax receipts thereby narrowing the Federal budget deficit. But what if the people use those tax cuts to pay off existing debt? What if the people save with those tax cuts? What if the tax cuts simply don't work? A thin line of perspiration breaks out on your upper lip.

The killer, the bane of the nation, are those blasted transfer payments, you tell yourself, the transfers and the damn state, municiipal and federal regulations. To say nothing of the built-in inefficiencies, the corruption, the make-work projects. You know you've got to cut into those – and fast. Furthermore, you know in your heart that perhaps 50% of everything done by government is either a boondoggle, a left-over from times past or an outrageous blow-up of some politician's pork barrel dream. But how do you get rid of this garbage? How do you undo the work of 40 years of post-World War II spending?

You clutch at your collar, and a tiny constriction grips your throat. Nobody said it was going to be easy, but now you're here and the dream is reality. What happens if you do succeed in cutting out some of the phoney agencies? What happens if you knock 20% or even 10% of the civil servants off the payroll? Not only will they hang you in effigy (you could stand that) but you know damn well that the nation would slide into recession or worse – depression. You'd be Ronnie Hoover, the scapegoat, the ex-actor who blew his biggest part.

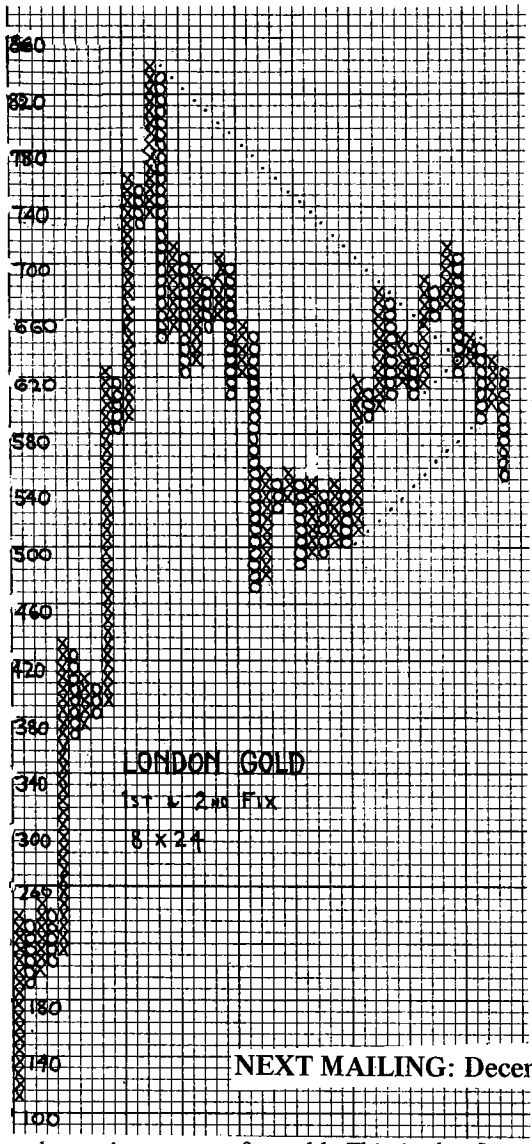
But you're 69 years of age, and you're not going to run again when this four years is over. So shouldn't you "go for it"? All those speeches you gave, all the times you talked about the people getting poorer and the government getting richer. Are you ready to slice the fat off the fat man? Shouldn't you just shut your eyes and let fly? You know "someone" has to do it. You've always been the fair-haired Dutch Reagan. How will you feel when ... and should you really ...?

**GOLD, SILVER:** Earlier this year silver crashed from a blow-off peak of $50 to a low of $10. Now the surest thing in any market is a recovery of at least 50% of the loss, following a true panic decline. A silver recovery should have taken the metal back to $30. The fact is that silver just about made it back to 24, then started sliding again. This was a VERY WEAK performance, and it started me watching silver closely. Last week silver did something it hasn't done in 5 years – it broke its 50-week moving average. On December 10 silver dropped back below 16. My own guess (call it a prediction) is that we'll see silver in the 6-9 level again.

Gold is a more difficult story because gold is real money, gold is held by the central banks and the IMF, and a lot of very big people and nations have a stake in high-priced gold. Of course, that's no guarantee of a high price, but when large interests (like Russia) are prone to manipulate the market, the picture is not as crystal clear as it might be.

What I feared about gold now seems to be occurring. The point & figure chart shows it all. First we had the record peak of 850 in January, 1980. Then we had the drop to 474, then the recovery to a lower peak of 720. But it becomes increasingly clear that the 720 peak was part of a second distribution in the metal, and as I've noted for many months, a large "head-and-shoulders" top formed on the gold chart.

On December 10 gold plunged below its major support at 600. The London fix on December 12 gold was 553, well below the

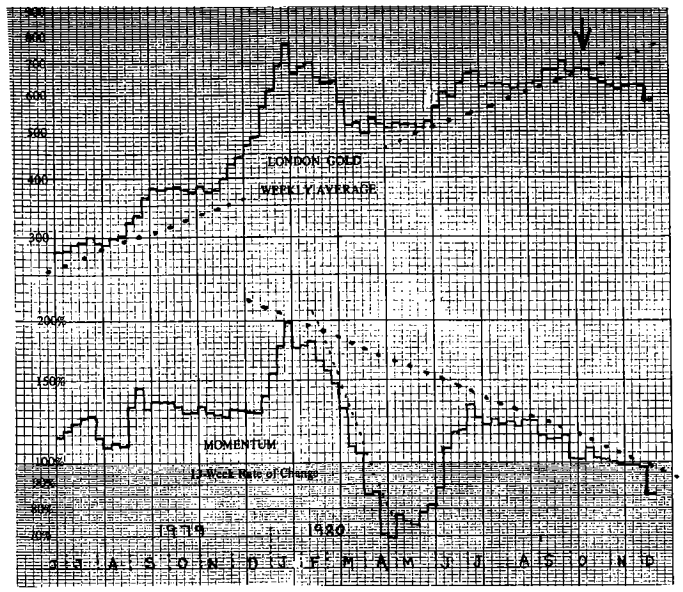


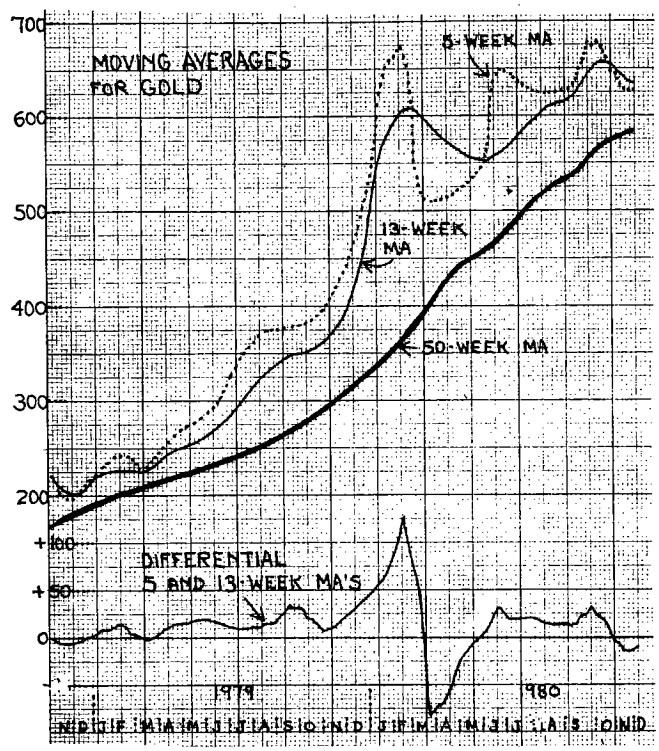

**NEXT MAILING: December 31st**

50-week moving average for gold. This is the first time in five years that gold has broken below its 50-week MA, and of course, that is not a bullish indication. In the last Letter I stated that if gold does not support above 585, the implications for the economy are deflationary. I am still of that opinion. To my mind, the smash of almost all the commodities plus silver and gold holds deflationary implications.

On the week ending Dec. 11 gold's average price was 584.20. This took my momentum (13-week rate-of-change) line down to 86, as you can see on the chart. In fact, when you look at this chart it is painfully clear that gold has been losing momentum ever since January (at which time momentum was 300). On the week of November 14 gold momentum broke below 100 for the first time in six months, and now its price is 86% of its price 13 weeks ago. I have not liked the momentum picture for gold all along, and as usual "the story is in the charts" if we would only trust those charts!

My final gold chart shows the three moving average (MA's) of gold. As of last week the short 5-week MA for gold was 610. a full 18 points below the 13-week MA, which now stands at 628. The long-term or 50-week MA for gold is now rolling over, and this MA stands at 584. It will be important to see whether gold can climb above 584 and hold there or whether the 50-week MA continues to come down.




My own guess is that 525-535 should offer significant support for gold, and you can see this support on the P & F chart. The low for the whole support area comes in at 472, the low for 1980. The action of gold already holds "dis-inflationary" implications. A drop below 470 would imply more than dis-inflation, it would suggest net deflation to me.

At any rate, if gold is to bottom in the 535-600 area, it is going to take a good deal of "work" and re-accumulation. If, as and when that occurs, we will see it on our various technical devices.

**LATE NOTES:** It's amazing. . . on Thursday, Dec. 11, the PTI came down and exactly touched that rising trendline. Then on Friday the market turned up again–just as it has done ever since July whenever the PTI has met the trendline. Now whether this is to be a feeble rally and then another slide, or the start of something much better, I do not know. Any sustained weakness during the week beginning December 15 will surely send the PTI below the trendline. But so far Transports have held above 360.87 and the PTI has held (but barely) above its trendline. How long the PTI can continue its tightrope act is anyone's guess.